

OPEN MEETING



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ORIGINAL

MEMORANDUM RECEIVED

2009 DEC 10 P 4:44

Arizona Corporation Commission

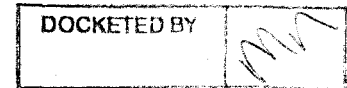
DOCKETED

DEC 10 2009

TO: THE COMMISSION AZ CORP COMMISSION
DOCKET CONTROL

FROM: Utilities Division

DATE: December 10, 2009



RE: IN THE MATTER OF THE NOTICE OF INTENT OF MCLEODUSA
TELECOMMUNICATIONS SERVICES, INC. D/B/A PAETEC BUSINESS
SERVICES PURSUANT TO A.A.C. R14-2-803 REGARDING A PRO FORMA
INTRACORPORATE REORGANIZATION, OR IN THE ALTERNATIVE,
APPLICATION FOR A LIMITED WAIVER OF A.A.C. R14-2-803 (DOCKET NO.
T-03267A-09-0536)

Introduction

On November 20, 2009, McLeodUSA Telecommunications, Inc. ("McLeodUSA") d/b/a PAETEC Business Services ("PAETEC", "Applicant" or "Company") submitted an application seeking approval to complete a reorganization by the end of the year due to significant benefits for the Company and requests expedited review and approval of this transaction without a hearing under A.A.C. R14-2-803(B). Alternatively, pursuant to A.A.C. R14-2-806, Applicant requests a limited waiver of A.A.C. R14-2-803.

Background

The Company in its Application represents the following:

1. PAETEC Business is an Iowa corporation with principal offices located at One Martha's Way, Hiawatha, Iowa 52233. PAETEC Business is an indirect wholly-owned subsidiary of PAETEC Holding Corp. ("PAETEC Holding"). In Arizona, PAETEC Business is authorized to provide resold and facilities-based local exchange and access services pursuant to Decision No. 62627, granted on June 9, 2000. PAETEC Business is also authorized to provide resold interexchange telecommunications services pursuant to Decision No. 61001, granted on July 16, 1998. According to its 2008 Annual Report filed with the Commission, the Applicant generated more than \$1 million of Arizona jurisdictional revenue. The Applicant therefore is a Class A investor owned public service corporation subject to the Arizona Corporation Commission's ("Commission") Public Utility Holding Companies and Affiliated Interest Rules, A.A.C. R14-801 et seq.

2. PAETEC Holding is a publicly traded Delaware corporation (NASDAQ GS: PAET) with principal offices located at One PAETEC Plaza, 600 Willow Brook Office Park, Fairport, New York 14450. In Arizona, PAETEC Holding provides regulated communications services through two wholly owned subsidiaries: PAETEC Business, and PAETEC Communications, Inc. ("PCI").

The Applicant's Transaction

The Company in its Application represents the following:

1. PAETEC Business will be included as part of a *pro forma* intracorporate reorganization of entities that all currently have PAETEC Holding as their ultimate parent. There will be no combination of unaffiliated entities. Currently, the Applicant is held by PAETEC Holding through the McLeodUSA Inc. and McLeodUSA Holdings, Inc. subsidiaries¹. The Applicant intends to execute a *pro forma* corporate reorganization whereby PAETEC Business will become an indirect wholly-owned subsidiary of PAETEC Holding under the PAETEC Corp. and PAETEC Communications, Inc. subsidiaries, rather than through its current intervening parent companies. McLeodUSA Inc. will be collapsed into PAETEC Holding Corp., and McLeodUSA Holdings, Inc.'s stock will be contributed to PAETEC Communications, Inc. There will be no changes in the corporate form, name, or manner in which PAETEC Communications, Inc. is held or operated².
2. In connection with the *pro forma* reorganization, PAETEC Business intends to undertake a change in corporate form whereby PAETEC Business will be converted from an Iowa business corporation to an Iowa limited liability company.
3. The conversion will not involve the merger of Applicant with any other entity. Rather, the conversion will be accomplished simply through the filing of Articles of Organization Including Articles of Conversion, or similar documents, with the Iowa secretary of state. This is similar to changing the name of a corporation under Arizona by filing revised Articles of Incorporation – the entity remains legally the same.
4. Under Iowa law, an entity that converts to a limited liability company is recognized as the same entity. When the conversion takes effect, the cessation of the existence of the converting business entity in its prior form of organization does not constitute a dissolution or termination of the converting business entity. The converting business entity ceases its prior form of organization and continues

¹ A diagram of the pre-reorganization structure of the company showing those entities is attached to the Application and here as Exhibit A.

² A diagram of the post-reorganization structure of the company is attached to the Application and here as Exhibit B.

in existence as the resulting limited liability company. As a result, there is no legal transfer of assets or a CC&N and no Commission approval is required.

5. The pro forma reorganization will not result in a transfer of control of PAETEC Business because its ultimate parent, PAETEC Holding, will remain the same. Furthermore, the day-to-day operations of the company will continue to be managed by the same personnel, and the transaction will not affect Applicant's current rates or services. The transaction will enhance the overall operational efficiency and competitive position of the company because it expects to gain significant benefits as a result of the pro forma reorganization, which will ultimately inure to the benefit of the companies' subscribers. Consequently, the transaction is consistent with the public interest, and will promote competition among telecommunications carriers in the state.

According to the Applicant, the structure changes are anticipated to produce the following benefits:

1. Result in more than \$800,000 in annual income tax savings by utilizing forecasted losses of certain subsidiaries against the forecasted profits of other subsidiaries;
2. Result in substantial administrative efficiencies to be achieved in the form of fewer income tax filings;
3. Mitigate current risks associated with limitations imposed on the ability to utilize net operating losses (i.e., Section 382 IRS loss limitations imposed on companies that have incurred an ownership change); and
4. Mitigate current transfer pricing risks associated with the accuracy of reporting inter-company transactions (e.g., meeting the arms length pricing standard for inter-company services incurred between affiliates – for example, the routing of an affiliate's calls over another affiliate's switch)."

Staff's Analysis

The proposed transaction constitutes reorganization under the Commission's Public Utility Holding Companies and Affiliated Interests Rules. Accordingly, information responsive to A.A.C. R14-2-803 (A.) 1. through 11 was provided by the Applicant in its filed application.

Additionally, at Staff's requests, the Applicant clarified the benefits stated in its application, as follows:

- The "\$800,000 in annual tax savings" is an estimated aggregate of annual state tax savings. No federal savings are anticipated from the restructuring. The majority of the state savings will be in Pennsylvania, Massachusetts, New Hampshire and New

York. The Arizona portion of tax saving is forecasted to be less than \$1,000 annually.

- The “substantial administrative efficiencies” are not forecasted to be monetary savings as much as administrative efficiencies for in-house staff who prepare the vast majority of the tax filings for the Applicant and affiliates. Fewer tax filings as a result of the conversion and reorganization will relieve in-house staff of some of the burden of preparing many forms.
- The “current risks” that will be mitigated associated with limitations imposed on the ability to utilize net operating losses were clarified as follows:
 - IRC Section 382 imposes an annual limitation on a corporation’s ability to utilize Net Operating Loss (“NOL”) carryovers if the company has incurred an “ownership change” within the meaning of Section 382 which was enacted in order to prevent companies from “loss shopping”. PAETEC Corp and its subsidiaries incurred an ownership change as a result of a recapitalization in 2006. Therefore, the NOL carryovers of the USLEC, McLeodUSA and PAETEC legal entities that arose before the respective ownership change dates (“pre-change NOLs”) are all subject to annual limitations with respect to the ability to offset taxable income arising after the ownership change date.
 - The proposed reorganization converts a number of legal entities to LLC’s (which are disregarded for federal and state income tax purposes) and results in the companies being considered as one filing entity for income tax purposes. This lessens, if not completely eliminates the potential impact of Section 382 at the state level as it allows for the inherent “netting” of McLeodUSA and USLEC forecasted Losses with PAETEC’s forecasted income without requiring the utilization of any of the pre-existing NOL’s.
- The “current transfer pricing risks” that will be mitigated associated with the accuracy of reporting inter-company transactions were clarified as follows:
 - The Internal Revenue Code Section 482 regulations specify that transactions between commonly controlled or related parties must adhere to the arm’s-length standard. The majority of states apply the 482 regulations.
 - To test whether transactions are conducted on an arm’s-length basis, the regulations have identified different methods according to the type of transaction. The requirement to prepare an economic analysis for each inter-company transaction can, in the aggregate, become a huge administrative undertaking requiring the dedication of limited internal resources and corporate personnel that could be better used on the company's core mission of providing high quality telecommunications service to the public.

- The proposed reorganization converts a number of legal entities to LLC's which are disregarded for federal and state income tax purposes. As a result, the administrative burden with regard to the arms length standard for inter-company transactions will be lessened, as the companies will be considered one filing entity for income tax reporting purposes.

Staff has reviewed the information provided by the Applicant and concluded that the information is in compliance with Commission's Public Utility Holding Companies and Affiliated Interests Rules and concurs that the proposed pro forma reorganization will not change the financial status of PAETEC Business, its ability to attract capital at fair and reasonable terms, or its ability to provide its authorized services service.

The Applicant has been found to be in compliance and good standing by the Commission's Compliance and Consumer Services sections.

Staff's Recommendations

Staff does not believe the reorganization proposed in this application will materially change the operations of PAETEC Business Services. Additionally, the nature of the reorganization is not sufficiently complex to require an evidentiary hearing. Staff, therefore, recommends that the application of McLeodUSA Telecommunications, Inc. d/b/a PAETEC Business Services be approved without a hearing under A.A.C. R14-2- 803(B).



Steven M. Olea
Director
Utilities Division

SMO:AFF:lhms\MAS

ORIGINATOR: Armando F. Fimbres

Exhibit A

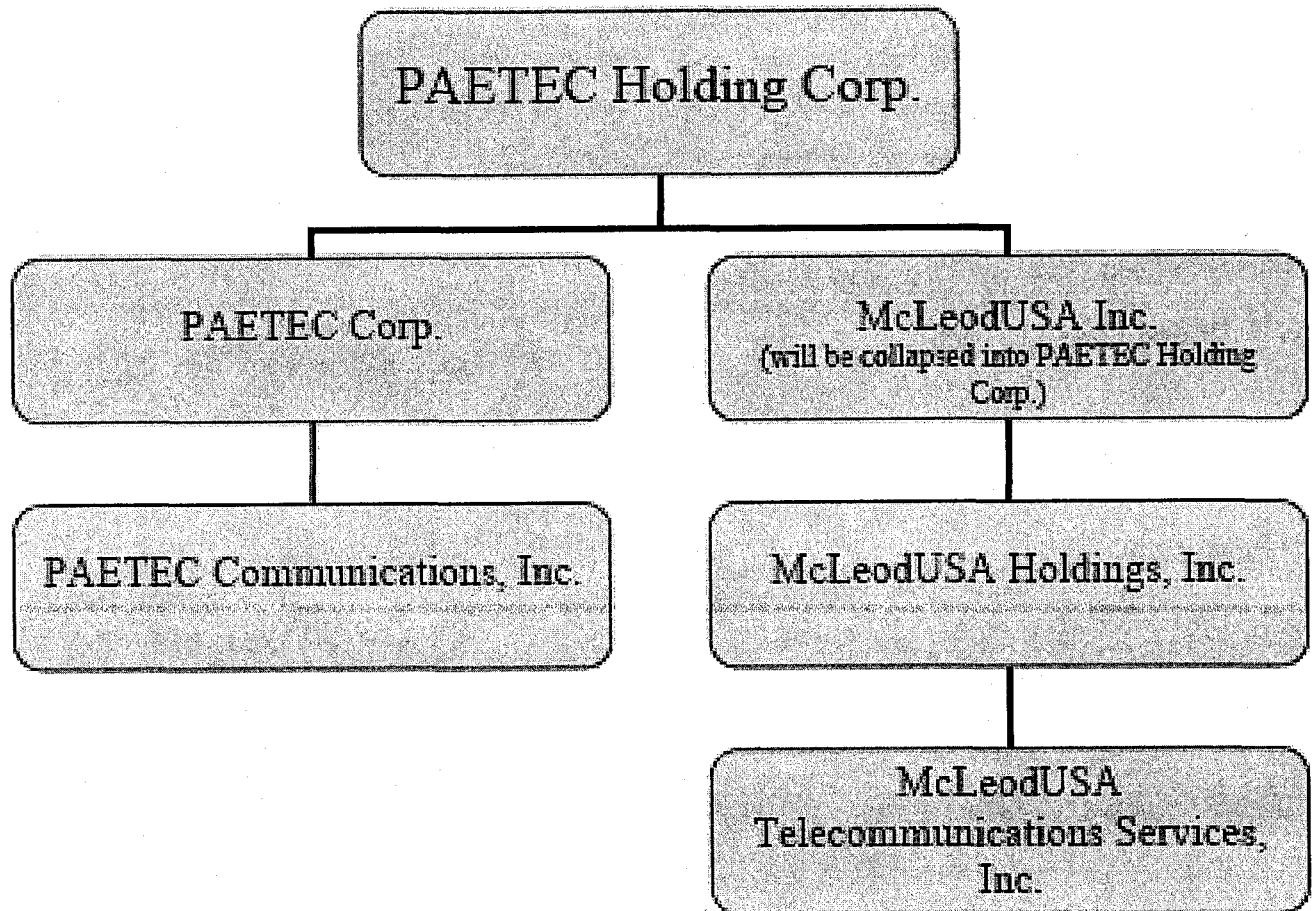
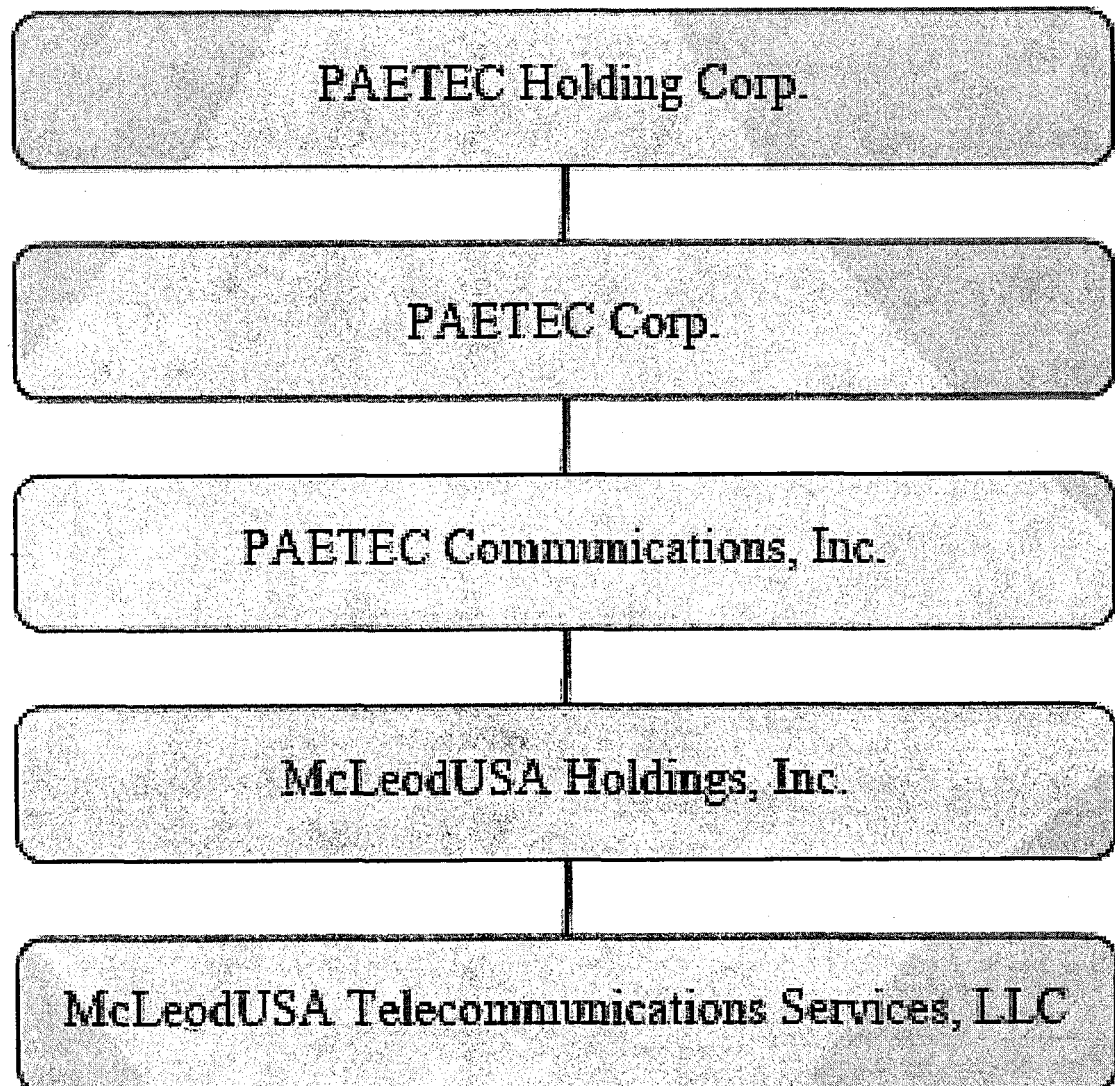


Exhibit B



1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

2 KRISTIN K. MAYES

Chairman

3 GARY PIERCE

Commissioner

4 PAUL NEWMAN

Commissioner

5 SANDRA D. KENNEDY

Commissioner

6 BOB STUMP

Commissioner

7
8 IN THE MATTER OF THE NOTICE OF
9 INTENT OF MCLEODUSA
10 TELECOMMUNICATIONS SERVICES,
11 INC. DBA PAETEC BUSINESS SERVICES
12 PURSUANT TO A.A.C. R14-2-803
13 REGARDING PRO FORMA
14 INTRACORPORATE REORGANIZATION,
15 OR IN THE ALTERNATIVE,
16 APPLICATION FOR A LIMITED WAIVER
17 OF A.A.C. R14-2-803

DOCKET NO. T-03267A-09-0536

DECISION NO. _____

ORDER

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Open Meeting
December 22, 2009
Phoenix, Arizona

BY THE COMMISSION:

FINDINGS OF FACT

1. On November 20, 2009, McLeodUSA Telecommunications, Inc. ("McLeodUSA") d/b/a PAETEC Business Services ("PAETEC", "Applicant" or "Company") submitted an application seeking approval to complete a reorganization by the end of the year due to significant benefits for the company and requests expedited review and approval of this transaction without a hearing under A.A.C. R14-2- 803(B). Alternatively, pursuant to A.A.C. R14-2-806, Applicant requests a limited waiver of A.A.C. R14-2-803.

Background of Applicants

2. The Company in its Application represents the following:

...

- PAETEC Business is an Iowa corporation with principal offices located at One Martha's Way, Hiawatha, Iowa 52233. PAETEC Business is an indirect wholly-owned subsidiary of PAETEC Holding Corp. ("PAETEC Holding"). In Arizona, PAETEC Business is authorized to provide resold and facilities-based local exchange and access services pursuant to Decision No. 62627, granted on June 9, 2000. PAETEC Business is also authorized to provide resold interexchange telecommunications services pursuant to Decision No. 61001, granted on July 16, 1998. According to its 2008 Annual Report filed with the Commission, the Applicant generated more than \$1 million of Arizona jurisdictional revenue. The Applicant therefore is a Class A investor owned public service corporation subject to the Arizona Corporation Commission's ("Commission") Public Utility Holding Companies and Affiliated Interest Rules, A.A.C. R14-801 et seq.

3. PAETEC Holding is a publicly traded Delaware corporation (NASDAQ GS: PAET) with principal offices located at One PAETEC Plaza, 600 Willow Brook Office Park, Fairport, New York 14450. In Arizona, PAETEC Holding provides regulated communications services through two wholly owned subsidiaries: PAETEC Business, and PAETEC Communications, Inc. ("PCI").

The Applicant's Transaction

4. The Applicants represent the following:

- PAETEC Business will be included as part of a pro forma intracorporate reorganization of entities that all currently have PAETEC Holding as their ultimate parent. There will be no combination of unaffiliated entities. Currently, the Applicant is held by PAETEC Holding through the McLeodUSA Inc. and McLeodUSA Holdings, Inc. subsidiaries.¹ The Applicant intends to execute a pro forma corporate reorganization whereby PAETEC Business will become an indirect wholly-owned subsidiary of PAETEC Holding under the PAETEC Corp. and PAETEC Communications, Inc. subsidiaries, rather than through its current intervening parent companies. McLeodUSA Inc. will be collapsed into PAETEC Holding Corp., and McLeodUSA Holdings, Inc.'s stock will be contributed to PAETEC Communications, Inc. There will be no changes in the corporate form, name, or manner in which PAETEC Communications, Inc. is held or operated².
- In connection with the pro forma reorganization, PAETEC Business intends to undertake a change in corporate form whereby PAETEC Business will be

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² A diagram of the post-reorganization structure of the company is attached to the Application and here as Exhibit B.

converted from an Iowa business corporation to an Iowa limited liability company.

5. The conversion will not involve the merger of Applicant with any other entity. Rather, the conversion will be accomplished simply through the filing of Articles of Organization including Articles of Conversion, or similar documents, with the Iowa Secretary of State. This is similar to changing the name of a corporation under Arizona by filing revised Articles of Incorporation – the entity remains legally the same.

6. Under Iowa law, an entity that converts to a limited liability company is recognized as the same entity. When the conversion takes effect, the cessation of the existence of the converting business entity in its prior form of organization does not constitute dissolution or termination of the converting business entity. The converting business entity ceases its prior form of organization and continues in existence as the resulting limited liability company. As a result, there is no legal transfer of assets or a CC&N and no Commission approval is required.

7. The pro forma reorganization will not result in a transfer of control of PAETEC Business because its ultimate parent, PAETEC Holding, will remain the same. Furthermore, the day-to-day operations of the Company will continue to be managed by the same personnel, and the transaction will not affect Applicant's current rates or services. The transaction will enhance the overall operational efficiency and competitive position of the Company because it expects to gain significant benefits as a result of the pro forma reorganization, which will ultimately inure to the benefit of the Companies' subscribers. Consequently, the transaction is consistent with the public interest, and will promote competition among telecommunications carriers in the state.

8. According to the Applicant, the structure changes are anticipated to produce the following benefits:

- Result in more than \$800,000 in annual income tax savings by utilizing forecasted losses of certain subsidiaries against the forecasted profits of other subsidiaries;
- Result in substantial administrative efficiencies to be achieved in the form of fewer income tax filings;

...

- Mitigate current risks associated with limitations imposed on the ability to utilize net operating losses (i.e., Section 382 IRS loss limitations imposed on companies that have incurred an ownership change); and
- Mitigate current transfer pricing risks associated with the accuracy of reporting inter-company transactions (e.g., meeting the arms length pricing standard for inter-company services incurred between affiliates – for example, the routing of an affiliate’s calls over another affiliate’s switch).”

Staff’s Analysis & Recommendations

9. The proposed transaction constitutes reorganization under the Commission’s Public Utility Holding Companies and Affiliated Interests Rules. Accordingly, information responsive to A.A.C. R14-2-803.A.1-11 was provided by the Applicant in its filed application.

10. Additionally, at Staff’s requests, the Applicant clarified the benefits stated in its application.

- The “\$800,000 in annual tax savings” is an estimated aggregate of annual state tax savings. No federal savings are anticipated from the restructuring. The majority of the state savings will be in Pennsylvania, Massachusetts, New Hampshire and New York. The Arizona portion of tax saving is forecasted to be less than \$1,000 annually.
- The “substantial administrative efficiencies” are not forecasted to be monetary savings as much as administrative efficiencies for in-house staff who prepare the vast majority of the tax filings for the Applicant and affiliates. Fewer tax filings as a result of the conversion and reorganization will relieve in-house staff of some of the burden of preparing many forms.
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- 1 – The proposed reorganization converts a number of legal entities to LLC's
2 (which are disregarded for federal and state income tax purposes) and
3 results in the companies being considered as one filing entity for income tax
4 purposes. This lessens, if not completely eliminates the potential impact of
5 Section 382 at the state level as it allows for the inherent "netting" of
6 McLeodUSA and USLEC forecasted Losses with PAETEC's forecasted
7 income without requiring the utilization of any of the pre-existing NOL's.
- 8 • The "current transfer pricing risks" that will be mitigated associated with the
9 accuracy of reporting inter-company transactions were clarified as follows:
 - 10 – The Internal Revenue Code Section 482 regulations specify that transactions
11 between commonly controlled or related parties must adhere to the arm's-
12 length standard. The majority of states apply the 482 regulations.
 - 13 – To test whether transactions are conducted on an arm's-length basis, the
14 regulations have identified different methods according to the type of
15 transaction. The requirement to prepare an economic analysis for each inter-
16 company transaction can, in the aggregate, become a huge administrative
17 undertaking requiring the dedication of limited internal resources and
18 corporate personnel that could be better used on the company's core mission
19 of providing high quality telecommunications service to the public.
 - 20 – The proposed reorganization converts a number of legal entities to LLC's
21 which are disregarded for federal and state income tax purposes. As a result,
22 the administrative burden with regard to the arms length standard for inter-
23 company transactions will be lessened, as the companies will be considered
24 one filing entity for income tax reporting purposes.

25 11. Staff has reviewed the information provided by the Applicant and concluded that
26 the information is in compliance with the Commission's Public Utility Holding Companies and
27 Affiliated Interests Rules and concurs that the proposed pro forma reorganization will not change
28 the financial status of PAETEC Business, its ability to attract capital at fair and reasonable terms,
29 or its ability to provide its authorized services.

30 12. The Applicant has been found to be in compliance and good standing by the
31 Commission's Compliance and Consumer Services sections.

32 13. Staff does not believe the reorganization proposed in this application will materially
33 change the operations of PAETEC Business Services. Additionally, the nature of the
34 reorganization is not sufficiently complex to require an evidentiary hearing. Staff, therefore,

1 recommends that the application of McLeodUSA Telecommunications, Inc. d/b/a PAETEC
2 Business Services be approved without a hearing under A.A.C. R14-2-803(B).

3 CONCLUSIONS OF LAW

4 1. McLeodUSA Telecommunications, Inc. d/b/a PAETEC Business Services is a
5 public service corporation within the meaning of Article XV of the Arizona Constitution.

6 2. The Commission has jurisdiction over McLeodUSA Telecommunications, Inc.
7 d/b/a PAETEC Business Services and of the subject matter in this filing.

8 3. The Commission, having reviewed the filing and Staff's Memorandum dated
9 December 10, 2009, concludes that it is in the public interest to grant the joint application of
10 McLeodUSA Telecommunications, Inc. d/b/a PAETEC Business Services to approve of this
11 transaction without a hearing under A.A.C. R14-2-803(B).

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ORDER

IT IS THEREFORE ORDERED that the application of McLeodUSA Telecommunications, Inc. d/b/a PAETEC Business Services seeking an order authorizing an intracorporate reorganization be and hereby is approved as discussed herein.

IT IS FURTHER ORDERED that this Decision shall be become effective immediately.

BY THE ORDER OF THE ARIZONA CORPORATION COMMISSION

CHAIRMAN

COMMISSIONER

COMMISSIONER

COMMISSIONER

COMMISSIONER

IN WITNESS WHEREOF, I, ERNEST G. JOHNSON, Executive Director of the Arizona Corporation Commission, have hereunto, set my hand and caused the official seal of this Commission to be affixed at the Capitol, in the City of Phoenix, this _____ day of _____, 2009.

ERNEST G. JOHNSON
EXECUTIVE DIRECTOR

DISSENT: _____

DISSENT: _____

SMO:AFF:lhM\MAS

1 SERVICE LIST FOR: McLeodUSA Telecommunications Services, Inc.
dba Paetec Business Services

2 DOCKET NO. T-03267A-09-0536

3
4 Mr. Michael W. Patten
Roshka DeWulf & Patten, PLC
5 One Arizona Center
400 East Van Buren, Suite 800
6 Phoenix, Arizona 85004

7 Mr. Tony S. Lee
8 Venable LLP
575 Seventh Street, N.W.
9 Washington, D.C. 20036

10 Mr. William A. Haas
11 Vice President of Public Policy & Regulatory
PAETEC Holding Corp.
12 One Martha's Way
Hiawatha, Iowa 52233

13 Mr. Steven M. Olea
14 Director, Utilities Division
15 Arizona Corporation Commission
1200 West Washington Street
16 Phoenix, Arizona 85007

17 Ms. Janice M. Alward
18 Chief Counsel, Legal Division
Arizona Corporation Commission
19 1200 West Washington Street
Phoenix, Arizona 85007

Exhibit A

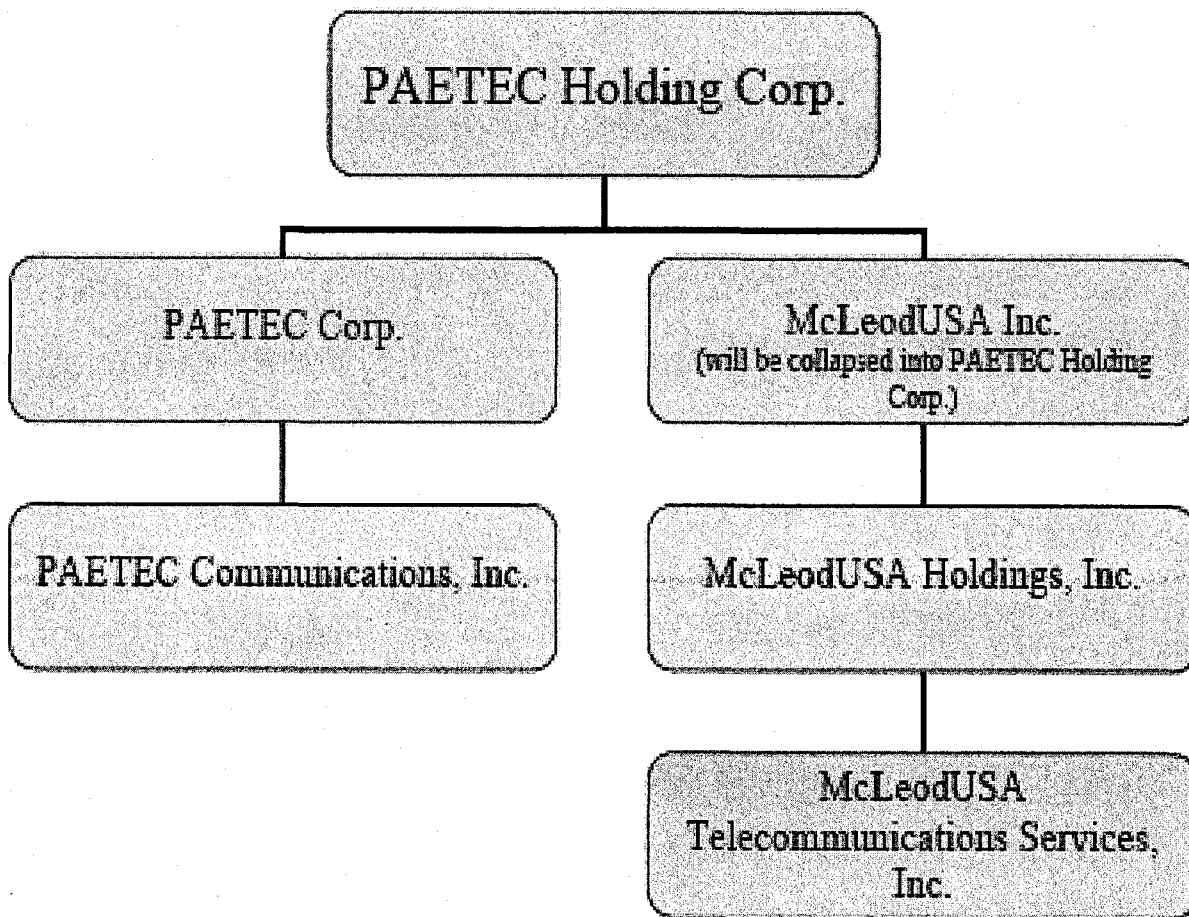


Exhibit B

